IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX REFERENCE No 196 of 1992

For Approval and Signature:

HON'BLE MR.JUSTICE M.S.SHAH
and
HON'BLE MR.JUSTICE A.M.KAPADIA

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : YES

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the concerned Magistrate/Magistrates,Judge/Judges,Tribunal/Tribunals? : NO

CREATIVE INVESTMENT P. LTD.

Versus

COMMISSIONER OF INCOME-TAX

Appearance:

1. INCOME TAX REFERENCE No. 196 of 1992
MR RK PATEL for Petitioner No. 1
MR MANISH R BHATT for Respondent No. 1

CORAM : HON'BLE MR.JUSTICE M.S.SHAH
and
HON'BLE MR.JUSTICE A.M.KAPADIA
Date of decision: 18/03/2004

ORAL JUDGEMENT

(Per : HON'BLE MR.JUSTICE M.S.SHAH)

In this reference at the instance of the assessee, the following questions have been referred for our opinion for assessment year 1984-85 :-

"1. Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in coming to the conclusion that provisions of section 104 were rightly invoked by the Assessing Authority and hence additional tax levied u/s. 104 was justified ?

2. Whether on the facts and in the circumstances of the case, the Tribunal is right in concluding that adequate dividends were not distributed due to excess provisions made for taxes ?

3. Whether the order of the Tribunal confirming levy of additional tax is reasonable, it having ignored alongwith the order facts and relevant case law, the material fact that provision for I.T. was made on the basis of assessed figure available at the time of paying advance tax, though subsequently reduced due to rectification order passed for A.Y. 1976-77 ?"

2. The assessee is a Company in which the public are not substantially interested within the meaning of Section 2(18) of the Income-tax Act, 1961 (hereinafter referred to as "the Act"). The total income assessed (before deductions under Chapter VI) was Rs.4,01,497/-. The assessee had made provision to the tune of Rs.3,30,000/- for income-tax and Rs.20,000/- for wealth-tax. The Assessing Officer gave set off of Rs.1,78,887/- as carried forward business loss as per the assessment orders for the previous years and the net profit of the assessee was assessed at Rs.2,59,384/-. The income-tax payable on the income was assessed at Rs.2,66,047/- and the wealth-tax payable was assessed at Rs.13,580/-. The Assessing Officer issued a notice under Section 104 calling upon the assessee to show cause why the provisions of Section 104 of the Act could not be invoked, because the Company had not distributed sufficient dividend to its shareholders out of the distributable surplus of Rs.1,21,870/- available with it and the statutory dividend worked out at Rs.1,09,683/= (at 90%) was not distributed, but only Rs.30,574/- was distributed. After obtaining the prior approval of the Inspecting Assistant Commissioner, the Assessing Officer invoked the provisions of Section 104 and taking into account the shortfall of dividend distributed, levied additional tax at 50% on undistributed profit. The

calculations made by the Assessing Officer are as under :-

a) Total income assessed by an order dtd.21.3.85 (before deduction under chapter VI)		4,01,497
b) Less : Tax payable		
i) Income-tax	2,66,047	
ii) W.T. (Paid)	- 13,580	2,79,627
c) Distributable surplus		1,21,870
d) Statutory %age to be distributed		90%
e) Minimum amount to be distributed as dividend		1,09,683
f) Dividend distributed		30,574
g) Shortfall of dividend distributed		79,109
h) Additional tax @ 50% on undistributed profit		39,555

Additional tax of Rs.39,555/- is levied u/s.104 of the I.T. Act.

The assessee carried the matter in appeal. The Commissioner of Income-tax (Appeals) held that having regard to the losses made by the assessee in the last 10 years, the dividend distributed by the assessee was reasonable as the reasonableness or unreasonableness of the amount distributed as dividend had to be judged by business considerations. The CIT(A) accordingly allowed the assessee's appeal. The department went in appeal before the Tribunal. The Tribunal held that due to excess provision made for taxes, adequate dividends were not distributed in the instant case and, therefore, the action of the Income-tax Officer in invoking Section 104 was justified.

The assessee had also filed cross objection contending that it was a trading Company and not an investment Company and, therefore, the statutory percentage for distribution of profits should have been adopted at 60% instead of 90% as done by the ITO. On this issue, the Tribunal remitted the matter to the CIT(A) for his consideration and decision.

In the present reference, all the three questions relate to justification on the part of the ITO in invoking the provisions of Section 104 and not the quantum of tax imposed under sub-section (1) of Section 104 of the Act.

3. We have heard Mr RK Patel, learned counsel for the assessee and Mr Manish R Bhatt, learned standing counsel for the revenue.

4. Mr Patel for the assessee has submitted that the CIT(A) had rightly allowed the assessee's appeal by taking into consideration the past losses which sub-section (2) of Section 104 itself requires the Assessing Officer to take into account and that as per the settled legal position the Assessing Officer was not required to act as tax collector, but the matter was required to be looked at from the prudent business man's point of view.

Heavy reliance has been placed on the decisions of the Apex Court in CIT vs. Gangadhar Banerjee & Co.Op. Ltd., (1965) 57 ITR 176, CIT vs. Jubilee Mills Ltd., (1968) 68 ITR 630 and CIT vs. Asiatic Textiles Ltd., (1971) 82 ITR 816. Reference is also made to a few more decisions rendered by the Calcutta High Court.

5. On the other hand, Mr Manish Bhatt, learned standing counsel for the revenue has submitted that the Assessing Officer and the Tribunal have rightly proceeded on the basis that for invoking the provisions of Section 104, it was not necessary to look at the profits and losses of the last 10 years. The assessee had made substantial profits in the last 5 years and the profits in the current year were also substantial and, therefore, the discretion exercised by the Assessing Officer has restored by the Tribunal is not required to be interfered with in this reference jurisdiction. Reliance is placed on the decision of the Patna High Court in CIT vs. Tiwary Bechar & Co.Ltd., (1995) 212 ITR 230.

6. Before dealing with the rival submissions, it is necessary to set out the relevant provisions of Section 104 of the Act which reads as under :-

"Income-tax on undistributed income of certain companies.

104.(1) Subject to the provisions of this Section ... ..., where the Income-tax Officer is

satisfied that in respect of any previous year the profits and gains distributed as dividends by any company within the twelve months from the date of expiry of the previous year are less than the statutory percentage of the distributable income of the Company of that previous year, the Income-tax Officer shall make an order in writing that the Company shall, part from the tax payable by it on the basis of the assessment under Section 143/144, be liable to pay income-tax at the rate of fifty percent in the case of an investment Company, thirty-seven percent in the case of a trading Company and twenty-five percent in the case of any other Company on the distributable surplus."

Clause (i) of sub-section (2), however, requires that the ITO shall not make any such order under sub-section (1) if he is satisfied that "having regard to the losses incurred by the Company in earlier years or to the smallness of the profits made in the previous year, the payment of a dividend or a larger divided than that declared within the period of twelve months referred to in sub-section (1) would be unreasonable."

7. In CIT vs. Gangadhar Banerjee & Co.Op. Ltd., (1965) 57 ITR 176, the Supreme Court considered similar provisions contained in Section 23A of the Indian Income-tax Act, 1922. There is no dispute about the fact that the provisions of Section 23A of the 1922 Act were similar to the provisions of Section 104 of the 1961 Act. The Apex Court laid down the following principles in the above case :-

"The Income-tax Officer, in considering whether the payment of a dividend or a larger dividend than that declared by a Company would be unreasonable within the meaning of Section 23A of the Indian Income-tax Act, 1922, does not assess any income to tax. He only does what the directors should have done putting himself in their place. Though the object of the section is to prevent evasion of tax, the provision must be worked not from the standpoint of the tax collector but from that of a businessman. The reasonableness or unreasonableness of the amount distributed as dividends is judged by business considerations, such as the previous losses, the present profits, the availability of surplus money and the reasonable requirements of the future and similar others. The Income-tax

Officer must take an overall picture of the financial position of the business. He should put himself in the position of a prudent businessman or the director of a Company and deal with the problem with a sympathetic and objective approach.

In deciding whether the payment of a dividend or a larger divided than that declared by the Company would be unreasonable, the Income-tax Officer can take into consideration circumstances other than losses and smallness of profit. The statute, by the words used, while making sure that "losses and smallness of profits" are never lost sight of, requires all matters relevant to the question of unreasonableness to be considered. Capital losses, if established, would be one of them."

(emphasis supplied)

8. Again in CIT vs. Jubilee Mills Ltd., (1968) 68 ITR 630, the Apex Court, while dealing with the provisions of Section 23A(1) of the 1922 Act, reiterated the above principles in the following language :-

"There was nothing in the language or context of section 23A(1) of the Act to suggest the expressing "losses incurred in earlier years" should be construed so as to exclude losses incurred prior to the reconstruction and to include only unadjusted or carried forward losses still outstanding in the books of the Company. The losses which had been adjusted in the books of the Company at the time of reconstruction did not cease to be "losses incurred by the Company in earlier years" within the meaning of Section 23A(1). The consideration of losses in the earlier years should be made in the setting and context of the inquiry whether the Company could be regarded as acting reasonably in declaring a smaller dividend. As a result of the losses having been adjusted against the paid up capital they no longer remained as unadjusted losses or carried forward losses but it did not mean that they ceased to have any impact on the financial position of the respondent in subsequent years. Even if the respondent resorted to the method of wiping out the losses by adjusting them against its capital, the procedure resulted in crippling its finances and the Company might in future

years reasonably take steps for improving its crippled financial position. If a Company which had got over its losses for some years by adjusting them against its capital and reducing its capital, made a profit in the subsequent year, it might theoretically be in a position to distribute the whole of its profits for that year but it could not be said to have acted unreasonably if it chose not to do so and retained a portion of the profits for the purpose of building up a capital reserve which in course of time would enable the Company to regain its original strength of capital which had been crippled by the adjustment of loses at the time of reconstruction. The Appellate Tribunal misdirected itself in law in holding that the losses incurred prior to the reconstruction of the respondent-Company were irrelevant for the purpose of the application of section 23A of the Act in subsequent years."

9. Again in CIT vs. Asiatic Textiles Ltd., (1971) 82 ITR 816, the Apex Court reiterated those principles in the following terms :-

"Whether in a particular year dividend should be declared or not is a matter primarily for the directors of a Company. The Income-tax Officer can step in under Section 23A(1) only if the directors unjustifiably refrain from declaring a dividend. If the directors of a Company had reasonable grounds for not declaring any dividend, it is not open for the Income-tax Officer to constitute himself as a super-director. The Income-tax Officer, in considering whether the payment of a dividend or a larger dividend than that declared by a Company would be unreasonable within the meaning of Section 23A of the Act, does not assess any income to tax. He only does what the directors should have done putting himself in their place. Though the object of the section is to prevent evasion of tax, the provision must be worked not from the standpoint of the tax collector but from that of a business man. The reasonableness or unreasonableness of the amount distributed as dividends is judged by business considerations, such as the previous losses, the present profits, the availability of surplus money and the reasonable requirements of the future and similar others. The Income-tax Officer must take an

overall picture of the financial position of the business. He should put himself in the position of a prudent businessman or the director of a Company and deal with the problem with a sympathetic and objective approach.

Capital loss, if established, is one of the matters relevant to the question whether the payment of a dividend or a larger dividend than that declared by the Company would be unreasonable."

(emphasis supplied)

10. It is thus clear that the losses incurred by the assessee in earlier years is a very important factor which is required to be taken into consideration before deciding whether the provisions of Section 104(1) are to be invoked or not. Though the Tribunal itself has not held that the losses of a particular number of years should only be taken into account, but since the Tribunal seems to have accepted the submission made on behalf of the revenue that the assessee was not justified in going back to ten years for considering the losses, it is necessary to look at the language of clause (i) of sub-section (2) of Section 104 which is quoted hereinabove. The statute does not put any limit on the number of "earlier years". The following chart at Annexure "L" in the paper book sets out the amounts of losses and profits for the last 10 years :-

A/c Year ending	Asstt. Year	Book Profit	Loss as	Net
30-06-73	1974-75	-	1,783	
30-06-74	1975-76	-	65,139	
30-06-75	1976-77	-	1,83,823	
30-06-76	1977-78	-	2,52,406	
30-06-77	1978-79	-	1,16,008	
30-06-78	1979-80	1,12,940	-	
30-06-79	1980-81	1,87,526	-	
30-06-80	1981-82	1,09,611	-	
30-06-81	1982-83	3,200	-	
30-06-82	1983-84	-	12,989	
30-06-83	1984-85	2,50,384	-	
		6,63,661	6,32,148	= 31,513

Net Book

		Profit
Dividend distributed Rs. 30,574	30,574	
Balance c/f	939	

The submission of Mr Bhatt for the revenue that since the losses were made in the assessment years 1974-75 to 1978-79 and that thereafter the assessee had made profits and, therefore, only the figures of the last five years should be looked at, cannot be accepted for the simple reason that in the year relevant to assessment year 1982-83 the assessee had made profits of only Rs.3,200/- and had incurred loss of Rs.12,980 in the year relevant to assessment year 1983-84. Hence, the assessee was justified in adopting a conservative approach while deciding that only Rs.30,574/- be distributed as dividend.

Another important aspect which is required to be noticed is that the total losses to the tune of Rs.1,78,887/- were set off in the year under consideration as stated in the assessment order. A close look at the statement of case filed with the return for the relevant year clearly indicates that the total loss of Rs.1,78,887/- was aggregate of the loss which was carried forward from 1977-78 onwards which was the seventh year before the relevant year. In the facts and circumstances of the case, it cannot be said that the assessee was not justified in taking into consideration the profits and losses of the last ten years. Taking into consideration the fact that the assessee had made a very small profit of Rs.3,200/- in the year relevant to assessment year 1982-83 and had in fact incurred the loss of Rs.12,989/- in the year relevant to assessment year 1983-84, the conservative approach adopted by the assessee appears to be quite justified and in view of the express provision of clause (i) of sub-section (2) of Section 104, the Assessing Officer was bound to look at the losses in the earlier years including the loss and profits made in the last ten years.

11. It appears from the Tribunal's order that what weighed with the Tribunal for setting aside the order of the CIT(A) was excess provision for taxation. Since the provision for taxation made by the assessee was Rs.3,30,000/- for income-tax and Rs.20,000/- for wealth-tax and ultimately the tax assessed as payable by the assessee was found to be Rs.2,66,047/- as income-tax and Rs.13,580/- as wealth-tax, the Tribunal has held that

the difference was available distributable surplus to the tune of about Rs.79,000/- and on this ground alone the Tribunal has set aside the order of the CIT(A) without at all dealing with the reason given by the CIT(A) that the past losses were required to be taken into consideration. Merely because the position that the assessee had made excess provision for taxes was undisputed, in view of the difference between the provision made for taxation and the tax ultimately held to be payable, it cannot be said that the assessee had not taken into consideration the past losses. On the contrary, the reply dated 30.3.1987 given by the assessee (Annexure "H") to the Inspecting Assistant Commissioner clearly stated as under :-

"Having regard to the nature of business - namely dealing in shares where the business income can greatly fluctuate and past losses the Directors thought it proper to plough back a part of the profit to meet future needs. This is out of commercial expediency. This is the first time that the Company could make such a profit. It is settled law that the Directors have to declare the dividend after taking into account all the factors including provisions of Companies Act."

(emphasis supplied)

12. In view of the above discussion, we are of the view that in view of the principles laid down by the Apex Court in CIT vs. Gangadhar Banerjee & Co.Op. Ltd., (1965) 57 ITR 176, CIT vs. Jubilee Mills Ltd., (1968) 68 ITR 630 and CIT vs. Asiatic Textiles Ltd., (1971) 82 ITR 816, the Tribunal erred in coming to the conclusion that the provisions of Section 104 were rightly invoked by the Assessing Authority and hence additional tax levied under Section 104 of the Act was justified.

13. Mr Bhatt for the revenue has relied on the decision of the Patna High Court in CIT vs. Tiwary Bechar & Co.Ltd., (1995) 212 ITR 230 in support of his contention that while determining the distributable surplus, only the tax actually found to be payable are required to be taken into account.

However, it is not necessary to go into the controversy as to whether it is permissible to take interest and penalty for the purpose of determining the extent of the amount on which the assessee will be liable to pay additional income-tax under Section 104 of the Act because we have proceeded on the basis that the

assessee's tax liability was only Rs.2,66,047/- for income-tax and Rs.13,580/- for wealth-tax. It is having regard to the losses incurred by the assessee in the earlier years that we have held that the the Tribunal erred in coming to the conclusion that the provisions of Section 104 were rightly invoked by the Assessing Authority and hence additional tax levied under Section 104 of the Act was justified.

14. In the result, our answer to question No.1 is in the negative i.e. in favour of the assessee and against the revenue.

As far as question Nos. 2 and 3 are concerned, they are merely argumentative and following our answer to question No.1, we answer question Nos. 2 and 3 also in the negative i.e. in favour of the assessee and against the revenue.

The reference accordingly stands disposed of.

(M.S. Shah, J.)

(A.M. Kapadia, J.)

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